STATE OF MAINE
PUBLIC UTILITIES COMMISSION

Docket No. 98-114

June 17, 1998

BANGOR HYDRO-ELECTRIC COMPANY
Plan for Divestiture of Generation Assets Pursuant to 35-A M.R.S.A. § 3204

ORDER

WELCH, Chairman; NUGENT, Commissioner

I. SUMMARY

The revised divestiture plan presented by Bangor Hydro-Electric Company (BHE, Bangor Hydro or the Company) is adequate, consistent with the Restructuring Act and reasonable. We therefore grant approval to that plan under 35-A M.R.S.A. § 3204.

BHE plans to auction off all but one of its generation assets. BHE includes its wholesale and retail marketing functions as generation assets subject to the auction, as well as its corporate name and some of its transmission assets.

BHE will not auction off the redevelopment potential of the Graham Station site, but instead has already entered into an option agreement to sell a portion of the site along with water and transmission access rights to a developer. We decide that the option agreement did not require Commission approval because further Commission action was contemplated before the actual sale was final. While auctions may be preferred, we approve the option agreement as part of the divestiture plan. We reserve, however, the ratemaking implications of the option agreement sale price. We also approve, to the extent necessary, pursuant to 35-A M.R.S.A. section 1101, the sale of the redevelopment site if the option is exercised.

II. BACKGROUND AND PROCEDURAL HISTORY

With the passage of “An Act to Restructure the State’s Electric Industry” (The Restructuring Act), Bangor Hydro is required, with certain exceptions, to divest all generation assets and all generation-related business activities by March 1, 2000. P.L. 1997, c. 316 (codified at 35-A M.R.S.A. § 3204). The Restructuring Act requires the divestiture to be accomplished according to a plan submitted to the Commission for review. The divestiture of generation assets is important both to ensure effective competition and to value generation assets for purposes of measuring stranded costs.

A. BHE's Initial and Revised Plan

On February 9, 1998, BHE filed a petition seeking Commission approval of its proposed divestiture plan pursuant to the requirements of the Restructuring Act. Under its plan as filed, BHE proposed to build on its pre-Restructuring Act (and continuing) discussions with potential purchasers of its generation assets to accomplish the required divestiture. BHE proposed to sell its generation assets and generation-related businesses through either of two processes, which would be pursued simultaneously: a negotiated sale growing out of pre-plan sale discussions or an auction process to solicit bids for purchase.

BHE later substantially revised its plan. The Company retained Reed Consulting Group as an advisor and now proposes to use an auction process exclusively for the sale of its generation assets and generation-related businesses,[1] with the exception of the Graham site at Veazie for which an option has already been sold to Casco Bay Energy Company, LLC. BHE also now proposes to solicit bids for some of its transmission assets, its wholesale and retail generation marketing functions, its entitlements to non-utility contracts, its corporate name, storage dams, hydro expansions and hydro rights owned by other corporations.

B. Bangor Hydro-Electric Generation Assets

Although it is the second largest electric utility in Maine, the assets that BHE is required to divest represent a smaller investment than those in other investor-owned utilities because of BHE's reliance on Maine Yankee Atomic Power Plant and non-utility generation and purchased power to serve most of its native load. BHE plans to offer for sale all of its hydro electric projects (33.25 MW of capacity at 6 sites). All but one of these facilities are currently operational, and all but one provide base load generation. BHE will also offer 11 diesel generators at three sites. Each unit operates only when necessary to supply shortfalls and regulate voltage. Together, the diesel units provide 12 MW of rated capacity.

In addition, Bangor Hydro offers its mothballed oil-fired steam units at Graham Station. Those two units together have 48 MW of rated capacity, but they have been

[1] BHE states that the Company still reserves the right to reject any or all bids and thereafter to engage in private negotiations or future auction processes.

deactivated since 1992. Consequently, a buyer would have to incur some additional expense to refire the units for production. More pertinent is this station’s potential as a site for redevelopment. Its location on the site of regional transmission facilities, and the anticipated construction of a gas transmission pipeline near the site, make it a uniquely attractive asset. As mentioned above, BHE has entered into an option agreement to sell real estate and other assets at this site that constitute the redevelopment value of the site.

BHE includes its 8.33% share of the oil fired Wyman Unit No. 4, representing 51.7 MW of capacity, for sale under its revised divestiture plan. BHE rejected CMP’s offer for an arrangement to bundle BHE’s fractional share with CMP’s share for sale as part of CMP’s divestiture plan implementation.

In its application, BHE lists separately several hydro projects for which it has initiated licensing procedures and for which final Federal Energy Regulatory Commission (FERC) processes are not complete. The proposed Basin Mills Hydro project would provide 38 MW of new capacity.[2] BHE also lists with the Basin Mills project two expansion projects at existing hydro electric facilities (1.6 MW at Milford and 8 MW at Veazie).[3]

Under its proposed plan, Bangor Hydro will also offer several generation-related businesses. BHE’s wholly-owned subsidiary, Penobscot Hydro Company, holds a 50% interest in a redeveloped hydro project (West Enfield). The redevelopment partnership has a long-term, qualifying facility contract to sell its output to BHE. At the end of the initial term BHE has contractual options either to purchase the facility at market value or to extend the supply arrangement at rates defined in the contract. BHE identifies three possible transactions: sale of its subsidiary; sale of the purchase option; and transfer of its rights to extend the power supply arrangement. The final option is not included as part of BHE’s proposed divestiture plan.

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[2] The FERC has recently rejected Bangor Hydro’s Basin Mills application but the opportunity for reconsideration and appeals still exists.

[3] The existing Milford and Veazie facilities were included in the earlier catalog of hydro facilities.

C. Procedural History

Timely petitions to intervene have been filed and granted on behalf of the Office of the Public Advocate (OPA) and the Maine Council of the Atlantic Salmon Federation (Maine Council). During the proceeding, BHE answered data requests, the Commission held a technical conference during which questions were answered by Doug Morrill and Alan Spear of the Company, and the intervenors and BHE filed comments and reply comments.

The OPA supported approval of BHE's plan but suggested concerns relating to sale of the corporate name and market power should be left to the sale of assets approval proceeding. The OPA also suggested that the Commission admonish the Company for entering into its option to sell a portion of the Graham site before plan approval. The Maine Council neither opposed nor supported the divestiture plan, but voiced its concern about the effect that divestiture may have on the current and potential proceedings for licensing of the hydro electric dams on the Penobscot and Union rivers. In reply, Bangor Hydro objected to OPA's suggestion that the Commission admonish the Company for the option agreement.

The Hearing Examiner recommended approval of the divestiture plan, except for the option agreement with Casco Bay. The Examiner recommended that the Commission void the option agreement because of BHE's failure to obtain approval of the option under 35-A M.R.S.A. § 1101. The Examiner did not recommend approval of the option agreement pursuant to either section 1101 or as part of BHE's divestiture plan because, without an auction-type process, the Commission could not be certain that Bangor Hydro maximized the value of the generation asset.

BHE excepted to the Examiner's recommendation because section 1101 approval and divestiture plan approval were not needed for Bangor Hydro to enter into the option agreement, and thus the option agreement was not voidable. As part of its exceptions, BHE now seeks an advisory opinion that future regulatory approval is not needed or alternatively seeks section 1101 approval. Moreover, BHE asserted that less value for stranded cost mitigation would be obtained by forcing BHE to reject the Casco Bay option and to seek bids for the assets at this time. The OPA reiterated that the option agreement should not be voided because timing concerns meant less value may be obtained in the future. The Maine Council urged approval of the option agreement in order to encourage the replacement of hydro-electric facilities by natural gas-fired power plants. At another technical conference held to consider the Examiner's Report, BHE and other parties provided additional evidence on the option agreement's requirement of further approval before actual closing of the deal and the effect on the value of the site of rejecting the Casco Bay option and putting the site up for auction in the near future.

III. REVIEW OF BHE'S PLAN

A. Option to Sell Graham Generation Redevelopment Site

Even before passage of the Restructuring Act, Casco Bay Energy Company, LLC (Casco) had been negotiating with BHE about the Graham Station site. Casco proposes to develop the site for construction of a new 520 MW natural gas-fired project, taking advantage of the site's proximity to the proposed Maritimes & Northeast gas transmission pipeline and the regional electric transmission system.

By January 1997, BHE had granted Casco an option to lease and sufficient possessory interests in the site for Casco to begin environmental permitting and processing for transmission system integration. As a result, the Casco project is 11th out of 46 projects on the NEPOOL application list for study and evaluation of integration with the NEPOOL transmission system.[4]

On January 16, 1998, Bangor Hydro entered into an option agreement with Casco to sell a portion of its Graham Station site in Veazie on the Penobscot River. In addition to the land transfer, BHE will relinquish its air emissions license and water intake and discharge facilities. Casco also obtains access to BHE's substantial transmission system at the site. Pursuant to the agreement, BHE received an immediate payment for granting Casco the option to purchase the site, and will receive monthly payments and a final payment if Casco exercises the option by December 31, 1998. Offsetting that, BHE is responsible for some expense for environmental remediation at the site.

In its offering memorandum, BHE excludes those assets subject to the option agreement from the bid process. The Graham Station assets that are available consist of the mothballed, oil-fired steam units #4 and #5, the structure housing those units and the land surrounding the structure. Of course, without the air emissions license and water intake and discharge facilities, the units could not be operated at that site, and it appears that the oil-fired steam units have value only if transported to a new location or used for parts.

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[4] All proposals for new generation or tie-line interconnection in the NEPOOL area must follow standard NEPOOL procedure to initiate and complete the NEPOOL interconnection study process. All applications are studied in the order received.

In its comments on BHE's plan, the OPA argues that, while the Commission may have the authority to void the option agreement, the Commission should not do so. Because Casco had a head start in developing the site, the OPA believes that other potential bidders will not find the value in the site that Casco found months ago. Instead, the OPA urges the Commission to "admonish the Company for proceeding with such an important agreement without the consultation and approval anticipated under Maine law."

Bangor Hydro takes exception to the OPA's request to admonish the Company. BHE does not deserve to be admonished, in the Company's view, because the Company had reached an agreement in principle concerning the option even before the passage of the Restructuring Act and it was not even clear to BHE that the land should be considered a generation asset within 35-A M.R.S.A. § 3204. BHE states that when BHE learned that the Commission would consider such undeveloped site as a generation asset, the Company accelerated the filing of its divestiture plan and included its option agreement as part of its original plan. Moreover, the Company states, customers may enjoy substantial benefits because the Company acted promptly to sell the site.

Following the Examiner's recommendation that the option agreement be voided, the Company asserted that approval of the option agreement itself was not necessary because approval of the actual sale transfer either would be sought or would be found unnecessary. Accordingly, the option agreement did not need section 1101 approval and is not voidable. BHE also asserts that the Graham site should not be considered a generation asset and therefore is outside the scope of its divestiture plan. BHE continues by asserting that, even if a generation asset, the option agreement should be permitted as BHE obtained maximum value and that because of timing concerns about transmission costs and gas supply, less value would be obtained if the site were auctioned now.

1. <u>Section 1101 Approval of the Option Agreement.</u>

It is now clear from BHE's exceptions and the technical conference responses that the option agreement by its terms is conditioned on necessary regulatory approvals and that BHE intends to seek approval or an explicit Commission ruling that approval is not necessary before title transfers to Casco.[5] Section 1101(1) provides that:

> A public utility must secure an order of authorization from the Commission before it may:
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> A. Sell, lease, assign, mortgage or otherwise dispose of or encumber the whole or part of its property that is necessary or useful in the performance of its duties to the public, or any part of its property under construction for the performance of its duties to the public, or its franchises, permits or rights under them

Because further Commission action must occur before title actually transfers to Casco, we hold that the option agreement does not constitute an encumbrance on BHE's property such that approval is necessary under Section 1101(1). In essence, the option agreement is like a conditional purchase and sale agreement, wherein Commission approval is sought prior to actual title transfer. As such, the option agreement is not void by operation of section 1101(2).

2. <u>The Option Agreement as Part of the Divestiture Plan.</u>

BHE's assertion that the assets optioned to Casco are not generation assets is mistaken. According to the Restructuring Act,

> "generation asset" includes all real estate, fixtures and personal property owned, controlled, operated or managed in connection

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[5] The option agreement states that:

> Bangor Hydro and Casco Bay shall cooperate in the identification of all consents, approvals ... or authorizations of ... any court, administrative agency or commission, including the Maine Public Utilities Commission ... that are required to be obtained ... . The foregoing consents, approvals ... are collectively referred to herein as the "Required Approvals." The obtaining of all Required Approvals shall be a condition precedent to the obligations of Casco Bay ... . Bangor Hydro shall promptly seek and diligently pursue the Required Approvals.

> with, or to facilitate, the generation of electric power.

35-A M.R.S.A. § 3201(10)

Real estate is explicitly included. The particular real estate in question is contiguous to transmission facilities. BHE includes air emissions licenses and water intake and discharge facilities in the option. All of these items are used in connection with and to facilitate the generation of electric power, and are part of the package of rights and property that are optioned to Casco. Indeed, BHE states that the best use of the land is to locate a generation facility on it. Casco acknowledges it will put the property to such use. It seems clear that the property in question fits the definition of “generation asset.”

Nevertheless, BHE’s sale of the option to Casco does not present an impediment to approving the plan; the execution of the option is, by its terms, subject to our approval (whether that approval is required under section 1101 or 3204). BHE still owns the generation site asset because title has not transferred to Casco. Accordingly, we construe BHE’s plan to include the divestiture of a part of the Graham Station site through private negotiations resulting in the option agreement, exercise of which requires a determination about Commission approval before title can actually transfer.

We approve the option agreement as part of BHE’s divestiture plan. We have been persuaded by the responses and affidavits submitted at the second technical conference that a risk exists that less value will be received now for the generation site, even for an optional sale now. By obtaining the property rights when it did, Casco is now 11th on the list of development projects for NEPOOL transmission access study. At the time of the second technical conference, 46 projects were on the list. Many of the projects are also gas-fired, so that gas supply concerns will also tend to reduce value that potential buyers will be willing to bid for the site. Thus, we agree with BHE and OPA that the time period in which Bangor Hydro entered into the option agreement was more likely to produce more value than a sale now or in the near future.

Under the Restructuring Act, not only must BHE divest, but must “pursue all reasonable means ... to receive the highest possible value for generation assets ... .” 35-A M.R.S.A. 3208(4). We continue to believe that auction processes are the most reasonable means to receive highest possible value. While we are not certain that BHE maximized the value received for its generation site when the Company negotiated the option agreement, we cannot be confident that an optimal sale at this time will produce as much value as BHE will receive under the option agreement. Our approval of the plan, including the option to Casco, does not insulate BHE from the ratemaking consequences of our finding, in the stranded cost proceeding, that BHE should have obtained a higher price at the time the option was granted. We decline, however, to risk compounding the injury to ratepayers by voiding a transaction that appears likely to have as much or more value than any alternative available today. Accordingly, we will not modify BHE's plan and will not require BHE to auction the redevelopment potential of the Graham Station site.[6]

3. Section 1101 Approval of the Sale.

In its exceptions, BHE seeks an advisory opinion that section 1101 approval is not necessary before title may transfer if Casco exercises its option, or alternatively that the Commission grant the section 1101 approval at this time. While their reasons differ, both Commissioners conclude that further approvals of the sale of the generation site are not necessary.

Commissioner Nugent concludes that section 1101 approval is necessary before title may transfer to Casco, and to approve the sale at this time. As a generation asset, the property in question remains used and useful utility property. Moreover, the materiality exception within section 1101(4) does not apply because the sale has such a measurable impact on the rates of the utility. Approval is proper at this time, however, in the context of this case. The generation asset must be divested by March 1, 2000. The option agreement defines the essential terms of the sale if it occurs. The Commission's approval of the option agreement as part of the divestiture plan, in which we reserve the ratemaking treatment associated with the sale price, leaves nothing else of any substance for the Commission to consider after the option is actually exercised.

Chairman Welch is willing to permit the sale of the site to proceed without further Commission action, but does so without deciding whether section 1101 approval is necessary. To the extent approval is necessary, Chairman Welch concludes that approval is warranted. As a result, it is unnecessary to

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[6] In the ratemaking proceeding, BHE should be prepared to demonstrate that the Company pursued all reasonable means to receive the highest possible value of the generation site. From evidence adduced in this proceeding, we are already concerned that the Casco negotiations based upon the Hagler Bailly appraisal failed to receive value for the fact that the site is already a generation site, avoiding NIMBY (not-in-my-backyard) problems.

decide whether the statute requires Commission approval on the facts presented here.

B. Bid Process

BHE's divestiture plan changed significantly from the original filing to the actual offering memorandum to prospective bidders. In its original plan, BHE stated that the Company might engage in an auction or private sale negotiations and that a sales advisor was not necessary. Subsequently, BHE hired Reed Consulting to act as a sales advisor and has further developed an auction or bid process of all generation assets except for the Graham site mentioned above. The revised plan includes the opportunity to purchase the wholesale and retail functions of the Company including the "Bangor Hydro" name, sale of contract entitlements and the sale of transmission assets.

We find the revised plan superior to the Company's initial plan. The revised plan allows flexibility in purchasing assets by not encouraging a single purchaser or the bundling of assets in an artificial manner. The plan has adequately solicited prospective purchasers. About 2800 letters were sent to prospective bidders. The information memorandum (5 looseleaf notebooks describing the generation assets) sent to prospective bidders who respond to the solicitation letter is appropriately informative with respect to the hydro plants and non-utility contracts.

C. Proposed Sale of the "Bangor Hydro" Name

BHE has proposed to sell its name and logo as part of its divestiture of its generation assets. Because the Bangor Hydro name is at least partially related to distribution functions, sale of the name can raise certain issues from the perspective of ratepayers. Specifically, although sale of the name may produce benefits that can reduce stranded investment, potential impediments to competition (customer confusion that might present market inefficiencies similar to vertical market power concerns) may affect ratepayer benefits from competitive markets and result in higher long-term costs to ratepayers. OPA raises these concerns in its comments.

Some of the value in selling BHE's name may be related to reliability of the distribution system and the reputation BHE has gained in performing customer service functions. It is possible that sale proceeds from the Bangor Hydro name will be sufficient that, from a stranded investment reduction prospective, the competitive concerns are offset by rate reductions. However, the Commission must have sufficient information to make this assessment. For example, if the sale proceeds from the Bangor Hydro name are minimal, the market efficiency risks may not be worth taking in comparison to the minimal benefits. On the other hand, if sale of the Bangor Hydro name alleviated a significant amount of BHE's stranded investment, the sale may indeed be in the best interest of ratepayers.[7] To have information for this assessment, potential purchasers should be required to separate their bids for the name from the other portions of the bid (e.g. even the retail business segment) and clearly specify how much of the bid price is for the Bangor Hydro name.

D. Sale of BHE's Diesel Generating Units

In its offering memorandum, BHE states that the diesel units "provide voltage support at the outskirts of the distribution system" and are used "to augment energy requirements during line maintenance." These statements raise the issue of whether the units are necessary to the efficient operation of the T&D utility and therefore should not be divested. In any proceeding addressing the sale of assets, BHE must demonstrate that divestiture of the diesel units is more economic than retention of the units by the utility.

E. BHE's Share in Wyman Unit 4

Discovery in this docket has uncovered an issue related to Wyman that is proper for the stranded cost case rather than this case: whether BHE adequately mitigated stranded costs when the Company declined to use CMP as "broker" for the sale of BHE's Wyman interest. As the opportunity to use CMP as broker has lapsed, we agree that BHE should now include its share of Wyman Unit 4 as part of its bid process.

Because FPL, CMP's winning bidder, does not want to purchase minority shares in Wyman, BHE may have difficulty in selling its minority interest in the plant. The value of minority shares in Wyman may be diminished currently because of uncertainty surrounding the strategy of FPL. For example, FPL may desire to convert the unit to gas or repower the unit as a combined cycle plant. If the best bid for the Wyman share is very low and FPL puts the plant to productive use, ratepayers could conceivably be better off by delaying the sale of Wyman. In other words, BHE should consider rejecting low bids for Wyman. The Wyman sale could be delayed until access occurs in 2000 without Commission approval, or after March 1, 2000 if an extension is applied for under the Act.

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[7] The issue is complex: a high sale price might indicate the buyers intention to exploit customer confusion, and a low sale price might suggest that little opportunity to distort the market exists.

F. Sale of Contract Entitlements

BHE is offering to either “assign” or “effectively transfer” power entitlements under its purchased power agreements. The long-term portion of these contracts represents approximately 52 MW of generating capacity. The Company has suggested the following two methods for selling the entitlements:

1) Buyers can bid a price (lump sum or annual) to acquire the energy and capacity, with BHE retaining the contracts;

2) Buyers can bid a payment required from BHE to assume full obligation under the contracts including assignment.

These two options involve locking in today’s expectation of market prices for all future years covered by the contracts. BHE’s sale strategy, with respect to the non-utility generator (NUG) contracts, raises the issue of whether it would be beneficial to allow periodic re-bids of the contracts. Under the Act, there is flexibility for BHE to sell entitlements after the generation capacity is sold. Specifically, BHE could sell the entitlements for relatively short time periods and re-bid the contracts thereafter. If market price expectations increase in the future, ratepayers would be better off with a periodic re-bid strategy. This would provide ratepayers with a hedge that does not exist under BHE’s proposed structure.

The ultimate sale of contract entitlements depends on the dollar purchase price offered for the entitlements and the sale of Wyman 4. If sale of Wyman is delayed, it may not be necessary from a hedging perspective to use a contract re-bid strategy. Similarly, if the bids for contract entitlements imply a low projected market price, BHE can reject all of the offers and re-bid the contracts at a later date similar to CMP.

G. Market Power and Transmission Issues

As we stated in our approval of the CMP divestiture plan, sales of generation assets that result in opportunities for the exercise of market power would be contrary to the goals of the Restructuring Act. However, because we believe concerns that an ultimate sale may result in market power are not grounds to reject a divestiture plan, we review market power issues to assist BHE in evaluating the bids. We will review both horizontal and vertical market power issues. Horizontal market power issues involve the question of whether sale of BHE’s assets can somehow create monopoly power for the asset purchaser.

Vertical market power deals with whether vertical integration of distribution, transmission and generation can create monopoly power.

Given the small size of BHE relative to other utilities in Maine and New England, horizontal market power is unlikely to be a concern with respect to BHE's sale. A greater potential for market power exists if BHE can become a load pocket where a single owner of generation could increase prices without competitive pressures. BHE has not examined the potential for horizontal market power as a result of the divestiture of its generation assets.

BHE asserts that there are no transmission constraints under normal (no contingency) conditions, which implies that there is not a load pocket under current capacity and load conditions. However, BHE acknowledges that generating units are, on occasion, dispatched out of merit order to avoid exceeding transmission/distribution limits. During these times, the units which are dispatched to support the transmission and distribution system could potentially exert monopoly power. In many of these cases, the units are the diesel plants discussed above. This situation may argue in favor of retaining the diesel units to protect ratepayers from any reasonable potential for exercise of horizontal market power.

Various potential vertical market power issues arise from BHE's divestiture plan. As we discussed above, sale of the Bangor Hydro name could present problems similar to market power concerns. Further, BHE is attempting to sell its interest of 100 MW of capacity reservation on the MEPCO transmission line. BHE owns a 14% share of MEPCO. BHE also offers its interest in a second tie-line to New Brunswick.[8] A purchaser of transmission assets that also owns generation could potentially use the transmission line to favor its own generation If BHE ultimately sells significant transmission and distribution assets to a generation owner, the Company should explain how such a sale does not have any potential to create vertical market power.

V. CONCLUSION

BHE's divestiture plan is approved. BHE shall proceed to divest its generation assets in accordance with this plan, and in a manner that addresses the concerns raised by the Commission in this Order.

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[8] BHE has obtained rights and/or options for all necessary rights of way to construct the second tie-line and has completed the necessary engineering studies and obtained all environmental, local and federal permits to construct the line.

Dated at Augusta, Maine this 17th day of June, 1998.

BY ORDER OF THE COMMISSION

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Dennis L. Keschl
Administrative Director

COMMISSIONERS VOTING FOR: WELCH (Concurring as described in the Order)
NUGENT (Concurring as described in the Order)

This document has been designated for publication.